Supreme Court
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No. 97-137

In the Supreme Court of the United States

OCTOBER TERM, 1996

TOM ANDERSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether income purportedly earned by a "business trust" was taxable to petitioner personally.

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OPINIONS BELOW

The order of the court of appeals (Pet. App. 2a) is unpublished, but the decision is noted at 106 F.3d 406 (Table). The opinion of the Tax Court (Pet. App. 7a-29a) is unofficially reported at 68 T.C.M. (CCH) 294.

JURISDICTION

The judgment of the court of appeals was entered on January 21, 1997. A petition for rehearing was denied on April 18, 1997 (Pet. App. 1a). The petition for a writ of certiorari was filed on July 17, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Beginning in 1982, petitioner operated a sole proprietorship named "Videolab," in which he manufactured, sold, modified and repaired video equipment (Pet. App. 9a). In January 1985, with the help of Frederick Ferber, a friend who was a sales representative for Nassau Life Insurance Company (Nassau Life), petitioner established two "common law business trust[s]" (*id.* at 10a). The first of these trusts was given the name "Para Technologies" (*id.* at 10a). Ferber was the "trustee" of Para Technologies, and petitioner was the "president" and owner of the entire beneficial interest in the so-called trust (*id.* at 10a-11a). As "president," petitioner had complete authority over the day-to-day operations of the "trust" (*id.* at 11a). Upon its formation, Para Technologies used the "Videolab" name in providing the same video engineering services petitioner formerly had provided in his sole proprietorship (*ibid.*).

At the same time that Para Technologies was formed, petitioner formed another so-called business trust named Atram Investment Group (Atram). This "trust" was purportedly situated in the Turks and Caicos Islands, British West Indies (Pet. App. 11a-12a). Nassau Life acted as trustee, and petitioner again was "president" and held the "beneficial interest" in Atram (*id.* at 12a).[1] As "president," petitioner had complete authority over the day-to-day operations of Atram (*ibid.*). Petitioner assigned his beneficial

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[1] Petitioner received 99 of the 100 "capital units" (*i.e.*, the beneficial interest) of Atram. The holder of the 1 other unit (a Nassau Life representative), however, had no involvement with Atram and received no distributions from the trust (Pet. App. 12a).

interest in Para Technologies to Atram, thereby making Atram the sole beneficiary of petitioner's Videolab business (*id.* at 13a).

Petitioner had agreed to assign certain technology to Atram in return for his "beneficial interest" (Pet. App. 13a). In August 1985, however, petitioner determined that he was unable to provide the technology. Atram released petitioner from his agreement to provide the technology purportedly in return for the surrender of 95 of his 99 "capital units." See note 1, *supra*. Atram then purportedly entered into an agreement with a "Mr. Smith" (a fictitious name used in this proceeding to protect that person's identity) to have "Mr. Smith" provide the technology in return for the 95 "capital units" of Atram (Pet. App. 13a-14a).

Petitioner opened several checking accounts in the names of "Videolab/Para Tech Technologies Trust" and Atram (Pet. App. 14a). He closed his only personal checking account and did not maintain any bank accounts in his own name (*ibid.*). During 1987 and 1988, petitioner paid his personal expenses with funds from the Atram and Videolab accounts (*id.* at 15a-16a). He also cashed checks on those accounts and made other checks payable to his mother, his sister and his girlfriend (*ibid.*). Petitioner was not required to reimburse the trusts for these expenses and did not receive any direct compensation for his work (*id.* at 24a).

On its U.S. Fiduciary Income Tax Return for 1987, Para Technologies reported net business income of $209,784.72 and claimed a deduction of $209,710 for distributions made to Atram (Jt. Exh. 1-A). On its 1988 return, Para Technologies reported net business income of $254,475.53 and claimed a deduction of $261,175 for distributions made to Atram (Jt. Exh.

2-B). On petitioner's personal income tax return for 1987 and 1988, he reported total income of $4,101.56 (Jt. Exh. 3-C) and $4,877.75 (Jt. Exh. 4-D), respectively.

2. In 1990, the Commissioner conducted an audit of Para Technologies (Pet. App. 19a-20a). In connection with that audit, petitioner hired a representative to meet and communicate with the government's representatives. The information and documentation sought by the government, however, was not made available (*ibid.*).

In 1991, the Internal Revenue Service issued a notice of deficiency to petitioner (Pet. App. 20a). The Commissioner determined that petitioner had failed to report income that he received from Para Technologies in the amount of $287,101 for 1987 and $233,341 for 1988 (*id.* at 42a). The Commissioner further determined that petitioner had acted fraudulently or, in the alternative, negligently in underpaying his tax for those years (*id.* at 39a, 41a) and that petitioner was liable for additions to tax for substantial understatement of his liability (*id.* at 39a).

3. Petitioner sought review of these determinations in the Tax Court. Petitioner contended that he neither owned nor received the income of the Para Technologies Trust and was therefore not liable to pay tax on that income. The Commissioner, however, took the position that Para Technologies and Atram were formed and operated as sham "trust" entities in an effort to conceal the fact that the economic benefits of the Videolab business inured to petitioner.

The Tax Court concluded from the evidence adduced at trial that Para Technologies and Atram were

"merely paper entities, devoid of economic substance and formed by [petitioner] only as a scheme to avoid taxation on the income from Videolab's business" (Pet. App. 21a). The court therefore held that the income purportedly received by Para Technolgies was taxable to petitioner (*id.* at 21a-22a). The court was unable to find "any meaningful relationship between Smith and Para Tech," and concluded that, even if there were, petitioner failed to link any specific portion of the income reported by Para Technology to "Mr. Smith" (*id.* at 22a). The Tax Court upheld the Commissioner's determination that petitioner had acted negligently in underpaying his income tax and concluded that he was liable for additions to tax for substantially understating his liabilities (*id.* at 27a-29a).

4. The court of appeals affirmed "for the reasons stated in the well-reasoned opinion of the United States Tax Court" (Pet. App. 2a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. This Court has noted that "the first principle of income taxation [is] that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740 (1949). Although a taxpayer has the right to shape his business transactions to minimize the incidence of taxation (see, *e.g.*, *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451, 455 (1950)), "the government is not required to acquiesce in the form chosen by taxpayers for doing business and, if the form is unreal and sham, the fiction may be dis-

regarded for purposes of the tax statutes." *Shaw Construction Co.* v. *Commissioner*, 323 F.2d 316, 319 (9th Cir. 1963).

The Tax Court correctly found that Para Technologies and Atram were sham entities that should not be recognized for federal income tax purposes. The so-called "business trusts" did not conform to any recognized trust concept; and the use of strangers or "straw men" as signers of organizational documents, and the failure of the nominal settlors to have any meaningful role in the operation of the "trusts," is persuasive evidence that such entities lack economic substance. See, *e.g.*, *Zmuda* v. *Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984); *Paulson* v. *Commissioner*, 992 F.2d 789, 790 (8th Cir. 1993). Moreover, in the present case, the creation of the purported trusts caused no meaningful change in the way in which the Videolab business was operated. Petitioner retained complete control over his business and its assets after the trusts were formed. The circular flow of money—petitioner performing work for Para Technologies for which he was not compensated, Para Technologies making distributions to Atram, and petitioner using Atram funds for the payment of his personal expenses—reflects that the asserted trust arrangements had no purpose or function other than tax avoidance. See, *e.g.*, *Akland* v. *Commissioner*, 46 T.C.M. (CCH) 51, 59-60 (1984), aff'd, 767 F.2d 618 (9th Cir. 1985). As the Tax Court found (Pet. App. 22a), there is also no convincing evidence to support petitioner's allegations regarding "Mr. Smith's" involvement in the business or linking "Mr. Smith" to any of the income earned by Para Technologies or Videolab. The Tax Court thus had an ample basis to conclude that the income purportedly "earned" by Para Tech-

nologies was in fact earned by, and therefore taxable to, petitioner.[2]

2. a. Petitioner errs in contending (Pet. 5, 16-19) that the Tax Court lacked jurisdiction because "the Commissioner did not make a substantive determination of the Taxpayer's income and tax imposed" (Pet. 5). The notice of deficiency (Pet. App. 39a-42a) shows that the Commissioner determined that petitioner received more than $200,000 in unreported income from Para Technologies in both 1987 and 1988 and that this income far exceeded the amount that petitioner reported on his returns.

b. Petitioner incorrectly asserts (Pet. 9-15) that his right to due process of law was violated because (i) the Commissioner did not examine his returns by correspondence or through an interview and (ii) petitioner was not permitted an administrative appeal of the Commissioner's determinations (Pet. 13). Petitioner bases these contentions on the Omnibus Taxpayer Bill of Rights, which was part of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 6226-6247, 102 Stat. 3730-3752. This legislation directs the Secretary of the Treasury to prepare and distribute to taxpayers a "statement" setting forth, among other things, "the rights of a taxpayer and the obligations of the Internal Revenue Service * * * during an audit" and "the procedures by which a taxpayer may appeal any adverse decision of the Service." § 6227(a)(1) and (2), 102 Stat. 3731.

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[2] Petitioner asserts (Pet. 7) that the Tax Court improperly ignored provisions relating to the taxation of trust income (26 U.S.C. 663, 674) in deciding this case. Because Para Technologies and Atram were sham trusts, however, the trust provisions of the Code were not applicable to this case (Pet. App. 21a-22a).

Petitioner contends that the Commissioner did not follow the provisions of the "statement" (Pet. App. 49a-60a, 62a-65a) in determining the deficiencies involved in the present case.

Even if that contention were correct, the Tax Court had jurisdiction in this case. The jurisdiction of the Tax Court is established simply from the facts that (i) the Commissioner issued a notice of deficiency and (ii) petitioner filed a timely petition for review of the deficiency in that court. See 26 U.S.C. 6213(a). Nothing in the Taxpayer Bill of Rights alters that established jurisdictional rule.

Moreover, the record reflects that an audit *was* conducted in 1990 and that petitioner, though participating, was uncooperative during that audit (Pet. App. 19a-20a). It was in connection with this audit that the Commissioner determined that Para Technologies and Atram were sham entities and that petitioner was liable for tax on the income earned by Videolab. Petitioner's contention that it was Para Technologies and Atram who were audited, rather than petitioner personally, simply misdescribes the scope and effect of the Commissioner's investigation. See pages 2-4, *supra*.

In any event, the "statement" issued by the Secretary of the Treasury pursuant to the Taxpayer Bill of Rights is not part of the Internal Revenue Code. Contrary to petitioner's assertion (Pet. 11), it is not "legislation" that provides taxpayers with legally enforceable rights that alter existing law. The audit procedures applied by the Commissioner, and the methods that are available for taxpayers to contest a determination by the Commissioner, are set forth in Part 601 of the Treasury Regulations. 26 C.F.R. 601.101 *et seq.* These procedural regulations are

internal guidelines that do not have the force of law. See, *e.g.*, *Gonsalves* v. *IRS*, 975 F.2d 13, 16 (1st Cir. 1992); *Ward* v. *Commissioner*, 784 F.2d 1424, 1430-1431 (9th Cir. 1986); *Boulez* v. *Commissioner*, 810 F.2d 209, 215 (D.C. Cir.), cert. denied, 484 U.S. 896 (1987); *Rosenberg* v. *Commissioner*, 450 F.2d 529 (10th Cir. 1971). The alleged failure of the Commissioner to provide an appeals conference before issuing the notice of deficiency, or otherwise to adhere to these administrative regulations, would neither deny petitioner due process of law nor deprive the Tax Court of jurisdiction in this case.

Petitioner received due process by petitioning for, and obtaining, review in the Tax Court and the court of appeals of the deficiencies determined by the Commisisoner. The Tax Court review occurred, as the law provides, without any requirement that petitioner first pay the disputed tax. In advance of any deprivation of property, petitioner thus received the opportunity to present evidence and dispute the Commissioner's determination. The requirements of due process are satisfied by the availability of judicial review in advance of the enforcement of the Commissioner's determination of tax. See *Phillips* v. *Commissioner*, 283 U.S. 589, 595 (1931).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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